

Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Associate Area Counsel ()
(Small Business/Self-Employed)

from: Christine Ellison
Branch Chief, Branch 3
(Passthroughs & Special Industries)

subject: Allocation of I.R.C. § 42 Tax Credits

This Chief Counsel Advice responds to your memorandum dated September 7, 2007. In accordance with § 6110(k)(3) of the Internal Revenue Code, Chief Counsel Advice may not be used or cited as precedent.

This memorandum is based solely on the facts presented in the September 7, 2007, memorandum and the exhibits received on October 26, 2007.

LEGEND

Taxpayer =

Managing Member =

Non-Managing Member =

YR1 =

YR2 =

YR3 =

W% =

X% =

Y% =

Z% =

A% =

B% =

ISSUE

Whether § 42 tax credits must be allocated in proportion to allocations of related depreciation deductions for the year giving rise to the credit, where special allocations in the partnership agreement result in the actual allocation of depreciation being different from the general allocations provided for in the partnership agreement?

CONCLUSION

Because the partnership expenditure that gives rise to the § 42 credit for the partnership taxable year also gives rise to valid allocations of partnership loss or deduction for the year, the partners' interests in the partnership regarding the § 42 credit are in the same proportion as the partners' respective distributive shares of the loss or deduction. Thus, § 42 tax credits must be allocated in the same proportion as the actual allocations of the related depreciation deductions giving rise to the credit for the year.

FACTS

Taxpayer was formed in YR1 by Managing Member and Non-Managing Member as a limited liability company to own and operate housing that qualifies for the low-income housing credit provided by § 42. Taxpayer is treated as a partnership for federal tax purposes under § 7701.

Taxpayer's Operating Agreement provides for capital accounts to be maintained in accordance with § 1.704-1(b). Managing Member is subject to an unqualified deficit restoration obligation, but Non-Managing Member is not. Instead, Non-Managing Member is the subject of a Qualified Income Offset.

The Operating Agreement provides that, in general, W% of Taxpayer's taxable income or loss is allocated to Managing Member, and X% of Taxpayer's taxable income or loss is allocated Non-Managing Member. However, prior to allocation of taxable income or

loss, the Operating Agreement requires certain special allocations to be made. Among these special allocations is the following provision: if losses otherwise allocable to the Non-Managing Member would cause the Non-Managing Member to have a deficit capital account, the losses are instead allocated to the Managing Member. In YR2 and YR3, allocation of X% losses to Non-Managing Member would have caused Non-Managing Member to have a deficit capital account. In accordance with the provision in the Operating Agreement relating to special allocations, only Y% of Taxpayer's nonrecourse deductions was allocated to Non-Managing Member in YR2, and only Z% of Taxpayer's nonrecourse deductions was allocated to Non-Managing Member in YR3.

LAW AND ANALYSIS

Section 702(a)(7) provides that each partner determines the partner's income tax by taking into account separately the partner's distributive share of the partnership's other items of income, gain, loss, deductions, or credit to the extent provided by regulations prescribed by the Secretary. Under § 1.702-1(a), the distributive share is determined under § 704 and § 1.704-1.

Section 704(a) provides that a partner's distributive share of income, gain, loss, deduction, or credit is, except as otherwise provided in chapter 1 of subtitle A of Title 26, determined by the partnership agreement. Under § 704(b), a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) is determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if (i) the partnership agreement does not provide for the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (ii) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) lacks substantial economic effect.

Section 1.704-1(b)(4)(ii) provides that allocations of tax credits and tax credit recapture (except for section 38 property) are not reflected by adjustments to the partners' capital accounts. Thus, these allocations cannot have economic effect under § 1.704-1(b)(2)(ii)(b)(1), and the tax credit and tax recapture must be allocated in accordance with the partners' interest in the partnership as of the time the credit or recapture arises. If a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustment) for the year, the partners' interests in the partnership regarding the credit (or the cost giving rise to it) are in the same proportion as the partners' respective distributive shares of the loss or deduction (and adjustments). See § 1.704-1(b)(5), Example 11.

For YR2 and YR3, Taxpayer seeks to allocate its § 42 tax credits between Managing Member and Non-Managing Member in accordance with the general allocation of W% to Managing Member and X% to Non-Managing Member. However, in YR2 and YR3, because of the provision in the Operating Agreement requiring special allocation of losses and deductions to Managing Member if allocation of those losses and deductions

to Non-Managing Member would have caused Non-Managing Member to have a deficit capital account, the depreciation deductions related to the property giving rise to the § 42 tax credits were actually allocated between Taxpayer's members in different percentages than the general allocations specified in the Operating Agreement. Because the partners' interests in Taxpayer regarding the credit in this case must be in the same proportion as the partners' respective distributive shares of the loss or deduction (or other downward capital account adjustment) for the year, the § 42 tax credits must be allocated, in YR 2, Y% to Non-Managing Member and A% to Managing Member; in YR3, the tax credits must be allocated Z% to Non-Managing Member and B% to Managing Member.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-3070 if you have any further questions.